DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 06-0186
Corporate Income Tax
For Tax Year 2002

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ISSUE

I. **Corporate Income Tax—**Capital Contributions.

Authority: IC § 6-2.1-1-2; *United States v. Chicago, Burlington & Quincy R. Co.*, 412 U.S. 401 (1973); *Brown Shoe Co., Inc. v. Commissioner*, 339 U.S. 583 (1950); *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943); *First National Bank of Richmond v. Turner*, 154 Ind. 456, 57 N.E. 110 (1890); *Hamilton Airport Advertising v. Hamilton*, 462 N.E.2d 228 (Ind. Ct. App. 1984); I.R.C. § 118; I.R.C. § 362; Black's Law Dictionary 201 (7th ed. 1999).

Taxpayer protests the assessment of gross income tax and adjusted gross income tax with respect to certain payments that Taxpayer maintains were third-party capital contributions.

STATEMENT OF FACTS

Taxpayer is a corporation created to engage in a variety of economic and community development projects. Business is a corporation that operated in City. Business' parent company also owned Taxpayer. When Business' parent company was purchased by an unrelated party, three options were presented to City for Taxpayer's ownership: City could own Taxpayer, Business could continue to own Taxpayer, or two particular individuals could own Taxpayer. City chose the option that allowed the two individual owners to own Taxpayer.

As part of an agreement between Business and City, Taxpayer received a portion of Business' adjusted gross receipts for housing in providing City. According to Taxpayer's protest, Taxpayer used the funds that it received to further its corporate purposes for community development, with neither City nor Business receiving direct benefits.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer. The Department assessed Taxpayer gross income tax, adjusted gross income tax (actually a reduction

in net operating losses permitted to be used in future years), and penalty on the assessment. Taxpayer protested the assessment. The Department conducted a hearing on the protest and this Supplemental Letter of Findings results. Additional facts will be supplied as necessary.

I. <u>Corporate Income Tax</u>—Capital Contributions.

DISCUSSION

Taxpayer's contention is that the amounts that Taxpayer received indirectly from Business (as determined by Business' receipts) constituted third-party capital contributions. Taxpayer argues that it treated the payments as paid-in capital excluded from income for federal tax purposes and that the same treatment should be afforded those payments under Indiana gross income tax and adjusted gross income tax laws.

Prior to repeal in 2003, IC § 6-2.1-1-2(a) provided that, "Except as expressly provided in this article, 'gross income' means all gross receipts a taxpayer receives: [list of ten sources]." In addition to nine specifically listed items, IC § 6-2.1-1-2(a)(10) provides that gross income includes receipts "from any other source not specifically described in this subsection."

One of the exceptions to gross income is IC § 6-2.1-1-2(c)(14), which provided that gross income does not include "the receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to the capital thereof ."

In Indiana, the term "capital" is defined by our case law as follows:

> When used with respect to the property of a corporation or association the term has a settled meaning; it applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed . . . .

First National Bank of Richmond v. Turner, 154 Ind. 456, 461-462, 57 N.E. 110, 112-113 (1890) (citing *Bailey v. Clark*, 88 U.S. 284 (1874)). This definition has not been altered in Indiana case law. *See Hamilton Airport Advertising v. Hamilton*, 462 N.E.2d 228, 238 (Ind. Ct. App. 1984). The common meaning of "capital contribution" is "1. Cash, property, or services contributed by partners to a partnership. 2. Funds made available by a shareholder, usu. without an increase in stock holdings." Black's Law Dictionary 201 (7th ed. 1999).

Ordinarily, shareholders, as opposed to non-shareholders, make capital contributions to corporations. However, the issue remains of whether a non-shareholder (i.e., Business) *can* make a payment to a corporation that qualifies as a capital contribution.

The argument that non-partners and non-shareholders may contribute capital to a corporation is supported by *Brown Shoe Co., Inc. v. Commissioner*, 339 U.S. 583 (1950). In *Brown Shoe*, local communities provided cash contributions as incentives to a manufacturer to locate in their towns. The Court held that the cash contributions were "'contributions to capital' within the meaning of

[1939 Internal Revenue Code] Sec. 113(a)(8)(B) [(now Sec. 362(a))]," and were therefore entitled to be depreciated. *Id*. at 589; *See also* I.R.C. § 362(c). The holding in *Brown Shoe,* which recognized that non-shareholders could make contributions to capital, was narrowed by the Court to those instances where there were neither customers nor payments for services. *Brown Shoe*, 339 U.S. at 589. The Court in *Brown Shoe* stated that:

> The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under those circumstances, the transfers manifested a definite purpose to enlarge the working capital of the company. *Id*. at 591.

In reaching its decision, the Court in *Brown Shoe* distinguished the case from the earlier case of *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943). In so doing, the Court stated that:

> [The *Detroit Edison*] decision denied inclusion in the base for depreciation of electric power lines the amount of payments received by the electric company for construction of the line extensions to the premises of applicants for service. It was held that to the extent of such payments the electric lines did not have cost to the taxpayer, and that such payments were neither gifts nor contributions to the taxpayer's capital. *Brown Shoe*, 339 U.S. at 591.

In *Detroit Edison*, "The payments were to the customer the price of the service [provided by taxpayer.]" *Detroit Edison*, 319 U.S. at 103. Therefore, the Court concluded, "it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company." *Id*. at 102.

The Court in *United States v. Chicago, Burlington & Quincy R. Co.*, 412 U.S. 401 (1973), summarized the distinctions made by *Detroit Edison* and *Brown Shoe* with regard to whether non-shareholders can remit monies to corporations as contributions to capital.

> Where the facts were such that the transferors could not be regarded as having intended to make contributions to the corporation, as in *Detroit Edison*, the assets transferred were not depreciable. But where the transfers were made with the purpose, not of receiving direct service or recompense, but only of obtaining advantage for the general community, as in *Brown Shoe*, the result was a contribution to capital.

Chicago, Burlington, 412 U.S. at 411.

> We can distill from these two cases [*Detroit Edison* and *Brown Shoe*] some of the characteristics of a non-shareholder contributor to capital under the Internal Revenue Codes. It certainly must become a permanent part of the transferee's working capital structure. It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. It must be bargained for. The asset transferred foreseeably must result in benefit to the transferee in an amount

> commensurate with its value. And the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Id. at 413.

Chicago, Burlington created a five-part test for third-party capital contributions. In applying the test, the perspective of the capital contribution is to be determined from the person making the contribution—in this case, Business. However, due to Taxpayer's refusal to provide information despite repeated requests from various entities, including City and the agency that regulates Business, the information known after the fact was extrapolated to determine Business' *ex ante* perspective.

With respect to the "working capital structure" element of the test, it is questionable whether a significant percentage of the payments made to Taxpayer became part of Taxpayer's capital structure. For 2002 to 2004, Taxpayer spent or incurred liabilities for the following amounts per its federal tax returns:

	2002		2003		2004
Officer compensation	$300,740		$785,143		$824,728
Salaries and wages	$174,190		$363,148		$414,631
Repairs and maintenance	$4,244		$1,606		$667
Rents	$5,940		$5,445		$5,940
Taxes & licenses	$30,264		$44,021		$44,574
Advertising	$38,119		$101,249		$175,440
Pension, profit-sharing	$322,396		$304,409		$307,427
Auto expense	$36,428		$5,204		$0
Auto lease	$41,127		$0		$0
Insurance	$49,917		$100,586		$123,321
Miscellaneous	$544		$2,437		$3,651
Office expense	$20,651		$9,479		$10,515
Professional fees	$269,146		$534,036		$1,135,193
Telephone	$40,454		$35,586		$37,727
Travel	$7,848		$14,838		$1,041
Lodging	$1,905		$10,323		$991
Dues & subscriptions	$4,667		$4,309		$4,551
Meals & entertainment	$38,878		$8,428		$2,708
Officer life insurance premiums	$41,289		$41,289		$41,289
Total	$1,428,747		$2,371,536		$3,134,394

Of the expenses in question, the officer compensation accrued to the shareholders. Of the salaries and wages, only $105,970.89 accrued to persons not related to the shareholders during the three years combined. The pension and profit sharing apparently accrued to the shareholders or their families.

Taxpayer also established limited liability companies (LLCs) to actually build and operate Taxpayer's housing developments. Of the LLCs, all but one arranged their capital structures in such a manner that shareholders and their families would eventually receive disproportionate distributions relative to their initial investments. At least one of these LLCs paid a minimum $50,000 in "development fees" to companies owned by the shareholder's families.

In the other LLC, Taxpayer's shareholders were guaranteed payments of $72,000 per year. Thus, Taxpayer's shareholders or their families received a *minimum* of $3,950,000 (including the pension payments) of Taxpayer's $6,700,000 intended for housing development over a three-year span.

Assuming *arguendo* that a housing unit costs an average of $250,000 to build but only results in $200,000 in revenue, and assuming that $2,100,000 per year in payments were received from Business to Taxpayer, roughly 180 housing units should have been built and sold by 2006. Instead, seventeen homes and one eighty-unit multi-family housing development have been built and sold from 1999 to 2006.

With respect to the "bargained for" element of a third-party capital contribution, little evidence exists that the payments were bargained for. Instead, the payments were required as a precondition for Business' operation in City. Thus, no bargaining occurred between Taxpayer and either Business or City with respect to the payments.

With respect to the assets being used to produce additional income, it is difficult to reconcile that the assets provided by Business—the payments to Taxpayer—were being used to produce income and the value of the payments being preserved by the production of income. For one thing, Taxpayer states that it could not and would not generate a profit—or even break even—with its sales of housing. In addition, Taxpayer used a significant portion of the payments that it received not for its housing objectives but for any number of expenses that benefited Taxpayer's shareholders and their families.

Based on the lack of money that became part of Taxpayer's capital structure, the lack of bargaining, and the lack of payments being used to produce additional income, Taxpayer has not provided sufficient information to conclude that the payments for 2002, 2003 and 2004 were capital contributions.

FINDING

Taxpayer's protest is denied.

I. Tax Administration—Penalty

DISCUSSION

Taxpayer protests the imposition of the ten percent negligence penalty on Taxpayer's deficiency.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1. The Indiana Administrative Code, 45 IAC 15-11-2 further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
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> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
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> (2) judicial precedents set by Indiana courts;
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> (3) judicial precedents established in jurisdictions outside Indiana;
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> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
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> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

With respect to the penalty, Taxpayer has presented sufficient information to indicate that its legal position was reasonable despite the Department's contrary conclusion.

FINDING

Taxpayer's protest is sustained.

JR/BK/DK–November 5, 2007